Macroprudential policy is a key defense line against global financial shocks*

By Katharina Bergant (IMF), Francesco Grigoli (IMF), Niels-Jakob Hansen (IMF), and Damiano Sandri (BIS)

Keywords: Macroprudential regulation, global financial shocks, capital controls.
JEL codes: F3, F4, E5.

Fluctuations in global financial markets can severely destabilize emerging market economies (EMEs). The academic and policy debate on enhancing EME resilience generally focuses on the role of capital controls and foreign exchange intervention, as these tools directly target international transactions. Yet, we find that macroprudential regulation—a less controversial policy tool—can already strongly bolster the resilience of EMEs against global financial shocks. Macroprudential regulation also facilitates a more countercyclical monetary policy response to fluctuations in global financial conditions.

*The views expressed herein are those of the authors and should not be attributed to the BIS, the IMF, its Executive Board, or its management.
In recent years, there has been a robust academic and policy debate on how to enhance the resilience of emerging market economies (EMEs) to the ebbs and flows of the global financial cycle. The discussion has focused on the use of foreign exchange intervention and capital controls since these tools directly target international transactions by offsetting or curbing capital flows, respectively. However, these tools are often controversial, partly due to concerns that they may be misused in a beggar-thy-neighbour manner.

In our study (Bergant et al., 2023), we show that a less controversial tool—namely macroprudential regulation—can be highly effective in bolstering the resilience of EMEs to global financial shocks and promoting a more countercyclical use of monetary policy.

**Macroprudential regulation bolsters macroeconomic resilience...**

The analysis is based on panel data for 38 EMEs between 2000 and 2019. The baseline empirical model examines whether the responsiveness of economic activity in EMEs to global financial shocks—captured by movements in the VIX, US monetary policy, and capital flows push factors—is influenced by the strength of macroprudential regulation. As illustrated in Figure 1, we find that when macroprudential regulation is weak, an increase in the VIX or a sudden capital outflow can significantly reduce GDP in EMEs. For example, a doubling of the VIX—as experienced during the global financial crisis—can reduce GDP in EMEs by 1.2 percent. However, macroprudential regulation can offset the impact of such shocks. Indeed, if macroprudential regulation is sufficiently stringent, global financial shocks do not have significant effects on EMEs’ economic activity.

**Figure 1: GDP response in EMEs to global financial shocks**

![Graph showing the GDP response in EMEs to global financial shocks](image)

Notes: The x-axis denotes the level of macroprudential regulation. Panels 1 and 2 show the GDP response to global financial shocks for different levels of macroprudential regulation; panel 3 shows the probability density function of macroprudential regulation in the sample. Net capital outflows are scaled by the HP-trend of GDP. The shaded areas correspond to 90 percent confidence intervals computed with Driscoll-Kraay standard errors.

We also examine if macroprudential regulation generates adverse cross-country spillovers. A possible concern is that if a country shields itself from fluctuations in global financial conditions through strict macroprudential regulation, other countries could become exposed to greater volatility. For example, measures that reduce risk taking in one country could lead to the relocation of risky financial activities to other countries, making them more susceptible to global financial shocks. However, we do not find evidence of such adverse spillovers. On the contrary, macroprudential regulation appears to have positive spillover effects when countries face capital flow shocks. This may be because countries with stringent macroprudential regulation support more stable trade and financial flows, benefiting other countries too.
Macroprudential policy is a key frontline defense against global financial shocks

...and enhances monetary policy independence

A potential mechanism through which macroprudential regulation reduces the sensitivity of EMEs’ economic activity to global financial shocks is by allowing for a more countercyclical monetary policy response. As shown in Figure 2, when macroprudential regulation is loose, an interest rate hike in the US or an increase in the VIX prompts EME central banks to raise rates, thereby weakening domestic activity. This is likely because central banks try to support the exchange rate and curb capital outflows due to concerns about financial stability. Conversely, when macroprudential regulation is sufficiently stringent, financial stability risks are less acute and central banks can respond more countercyclically, for example by cutting interest rates in response to a rise in the VIX.

Figure 2: Policy rate response in EMEs to global financial shocks

Notes: The x-axis denotes the level of macroprudential regulation. Panels 1 to 2 show the policy rate response to global financial shocks for different levels of macroprudential regulation; panel 3 shows the probability density function of macroprudential regulation in the sample. Net capital outflows are scaled by the HP-trend of GDP. The shaded areas correspond to 90 percent confidence intervals computed with Driscoll-Kraay standard errors.

Policy implications

Our findings demonstrate the effectiveness of macroprudential regulation in mitigating the macroeconomic impact of global financial shocks on EMEs and in facilitating a more countercyclical response of monetary policy. These results are particularly relevant from a policymaking perspective because we do not find evidence that capital controls provide similar benefits. As a result, our analysis strongly advocates for the use of macroprudential regulation as a critical defense line against the destabilizing effects of global financial volatility.

References

Macroprudential policy is a key frontline defense against global financial shocks.

**About the authors**

**Katharina Bergant** is an Economist in the Macro-Financial division of the Research Department at the International Monetary Fund. In addition to her work on monetary and macroprudential policies, her most recent research focuses on the application of microdata in international financial macroeconomics. Her work has been published in several peer-reviewed journals, such as the Journal of Finance. Before she joined the IMF, Katharina did a research fellowship at the Harvard Kennedy School. Previously, she worked in the Directorate Economics of the European Central Bank and the Monetary Policy division of the Central Bank of Ireland. Katharina was a Grattan Scholar at Trinity College Dublin where she earned her PhD under the supervision of Philip R. Lane.

**Francesco Grigoli** is a Senior Economist in the Research Department of the International Monetary Fund (IMF) and an adjunct professor at Georgetown University. Previously, he worked in the IMF’s Fiscal Affairs Department and Western Hemisphere Department and was a visiting scholar at Columbia University. He published extensively in leading academic journals and policy outlets on a wide range of topics in macroeconomics and international economics. His current research focuses on inflation expectations, price formation, monetary policy, and international finance. Francesco received his PhD in Economics from the University of Insubria and holds a Master's in International Economics from the University of Sussex.

**Niels-Jakob H. Hansen** is an Economist in the IMF’s Western Hemisphere Department covering Ecuador. Previously he was in the World Economic Studies Division of the Research Department contributing to chapters of the World Economic Outlook. He also worked in the Asia Pacific Department and Finance Department, and has participated in missions to Korea, Cambodia, Czech Republic, and San Marino. He has also worked on issues related to Fund finances. His research interests include monetary and labor market issues, and has published in the Review of Economic Studies, IMF Economic Review, Labor Economics, Journal of Health Economics, and Journal of Economic Inequality. He holds a Ph.D. in Economics from the Institute for International Economic Studies at Stockholm University, an MPhil in Economics from University of Cambridge, and an MSc in Economics from University of Copenhagen (cand.polit).

**Damiano Sandri** is a Principal Economist at the Bank for International Settlements and a CEPR Research Fellow. Prior to joining the BIS, Damiano was a Deputy Division Chief in the Research Department of the International Monetary Fund. His research focuses on macro-financial issues, monetary policy, and international finance and has been published in leading academic journals and policy outlets. Damiano has worked as Associate Editor of the IMF Economic Review and holds a PhD in Economics from the Johns Hopkins University.

**SUERF Publications**

Find more SUERF Policy Briefs and Policy Notes at [www.suerf.org/policynotes](http://www.suerf.org/policynotes)

SUERF is a network association of central bankers and regulators, academics, and practitioners in the financial sector. The focus of the association is on the analysis, discussion and understanding of financial markets and institutions, the monetary economy, the conduct of regulation, supervision and monetary policy.

SUERF’s events and publications provide a unique European network for the analysis and discussion of these and related issues.

**SUERF Policy Briefs (SPBs)** serve to promote SUERF Members’ economic views and research findings as well as economic policy-oriented analyses. They address topical issues and propose solutions to current economic and financial challenges. SPBs serve to increase the international visibility of SUERF Members’ analyses and research.

The views expressed are those of the author(s) and not necessarily those of the institution(s) the author(s) is/are affiliated with.

All rights reserved.

**Editorial Board**

Ernest Gnan
Frank Lierman
David T. Llewellyn
Donato Masciandaro
Natacha Valla

**SUERF Secretariat**

c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
www.suerf.org • suerf@oeb.at